Commentary - 2nd Quarter 2009

Greetings from a much happier place. We have come a long ways in the last year. I just re-read our quarterly report from the third quarter of 2008 and it reminded me of how precarious the financial system's survival was at the time. At the end of last September, the Dow Jones Industrials was still trading above 10,800, but at the time of writing the reports, Congress was voting on whether or not to approve the $700 billion TARP package. October of last year saw the mind-numbing drop in the stock market that exceeded 2,000 points on the Dow. Volatility in stock prices shocked us all. The flight to quality wiped out many leveraged investors.

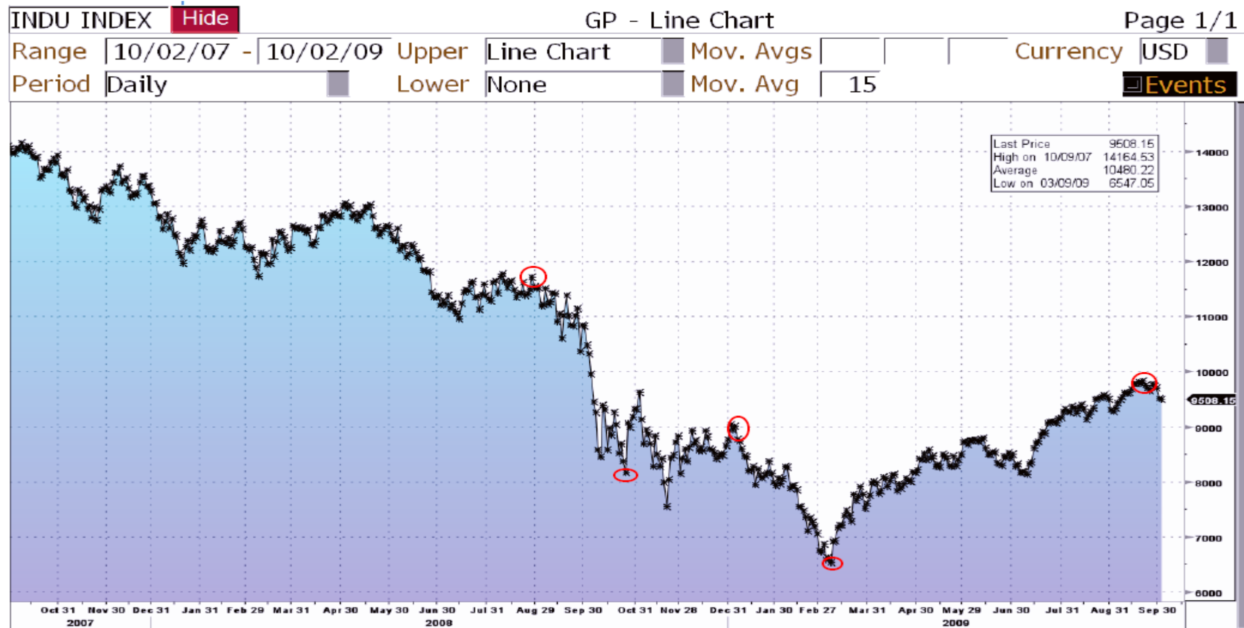
Now the argument between financial analysts is whether the strength of the economic recovery justifies the strong rally we have experienced in the stock market since March. The worst of the credit crisis is past. The tsunami has receded and now we have to deal with cleaning up the mess and rebuilding. Banks have been successful in raising capital to repair their balance sheets, though they will still have to endure more loan losses. Many corporations have been able to refinance maturing debt or issue new debt to replace bank credit lines or commercial paper. The additional interest that corporations must pay to entice investors to purchase their debt versus what the U.S. Treasury pays has declined to levels more associated with a weak economy rather than a depression. Count us in the optimistic camp. We are still bullish on America.

We recently read an interesting commentary from James Grant, publisher of Grant's Interest Rate Observer, who is typically a very cautious, conservative financial prognosticator. He suggests that the typical economic recovery is proportionate to the economic decline and the stock market movements mirror the economic patterns. The stock market deteriorated from October, 2007 through the summer of 2008 as problems in the subprime mortgage area caused problems with the banking system. The economy was hurting at the same time, but its rate of decline was moderate. Not until Lehman Brothers failed, causing a surge in money market fund redemptions and government support of the banking system; did the stock market and the economy collapse.

As you can see on the graph of the Dow below, the sell-off in fourth quarter last year was dramatic. At the same time, the economy contracted by almost 6%, the worst quarter for the economy in over twenty-five years. The economy declined again in the first quarter this year, by another 6%. But the stock market was already beginning to recover in March because the steps the Treasury and the Fed were taking were expected to stem the economic decline and stimulate economic recovery. The economy declined slightly in the second quarter; however, it is expected to turn in a decent growth report for the third quarter. We think the current monetary conditions will stimulate a sustained recovery in the economy. If

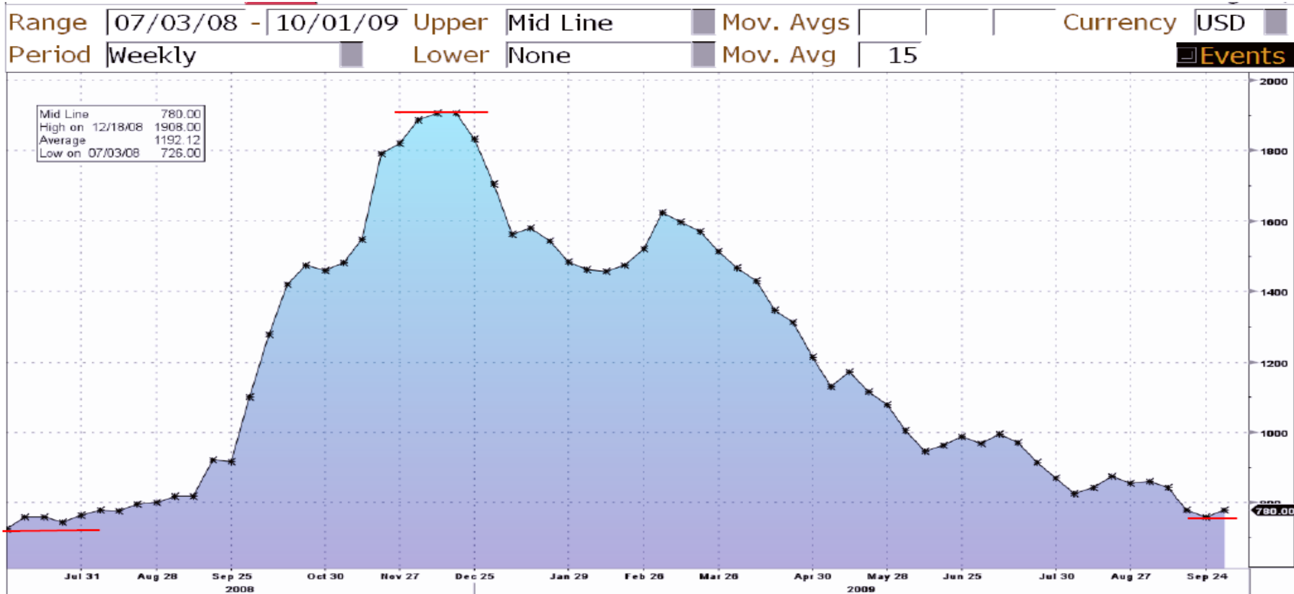
businesses experience higher revenues, earnings will improve and they will hire more workers. That is what the stock market is predicting right now.

Graph 1. Dow Jones Industrials Average Source: Bloomberg



For the Fed's low interest rates and easy monetary policy to stimulate the economy, credit spreads needed to improve from the onerous levels they reached last year. Credit spreads are an indication of the higher interest rates that private borrowers must pay versus what the government pays. A wide spread suggests investors do not expect borrowers to be able to meet their payments while narrow spreads suggest investors will have little trouble meeting their obligations. Last fall, these spreads widened to levels we had not seen before. The Fed knew that private borrowers could not be expected to maintain their business activity if they had to pay such exorbitant rates. The Fed worked feverishly to bring those rates down and did so by purchasing bonds in the open market and expanding their credit facilities such as the Term Asset Backed Lending Facility (TALF). They have been successful as shown in our favorite graph of this credit crisis, the high yield bond spread, shown below.

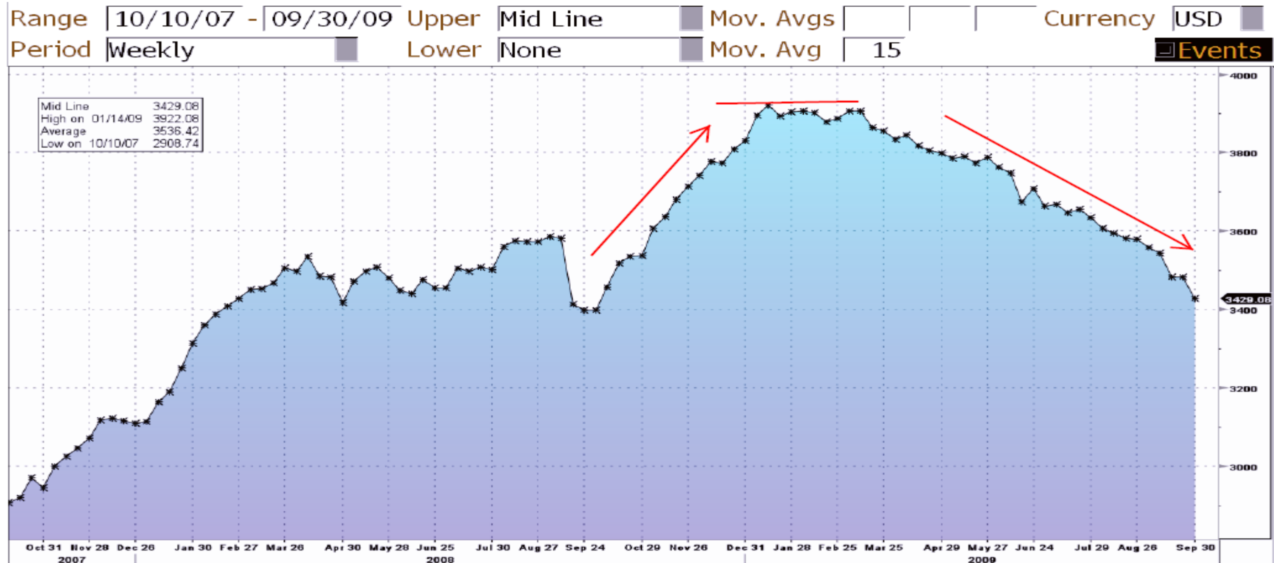
Graph 2. CSFB High Yield Index, Spread to Worst   Source: Bloomberg



The index spread was 7.26% over Treasuries in July, 2008 and reached almost 20% in December, 2008. It is now back to less than 8.0%. The long term average is closer to 5.0%. The spread indicates that investors are still worried about economic weakness leading to defaults, but not nearly as much as nine months ago. If we are correct, and the economic recovery builds steam, then these credit spreads will continue to fall. The decline in credit spreads supports Jim Grant's suggestion that the economy will improve and the stock market can go higher.

Two more items give us reason to be optimistic. First, businesses are starting to use their cash to make acquisitions. They had been conserving cash while the credit markets were closed. We read last month that corporations had built up $14 trillion in cash reserves. Now, each Monday new deals are announced. Last week it was Xerox purchasing Affiliated Computer Systems and a couple of pharmaceutical deals. The week before it was Dell acquiring Perot Systems. If businesses have the confidence that conditions will continue to improve, then they want to invest in growth opportunities. The second reason for a positive outlook is that money market fund balances are coming down. The fear that lead to a huge run up in money market fund balances is dissipating. The graph below shows how money market fund totals increased throughout the financial panic and are now declining.

Graph 3. Total Money Market Fund Assets Source: Bloomberg



With the Fed keeping short term interest rates anchored close to zero, we should continue to see investors move money out of money market funds into high yielding securities. That will help provide liquidity to the private sector.

On a cautionary note, interest rates on Treasury notes and bonds declined more than expected over the last couple of months. This drop in rates may suggest that the deflationary forces that the Fed is fighting will be difficult to overcome. The majority of investors are still risk adverse and are investing in bonds rather than stocks. Mutual fund inflows are running about 7:1 in favor of bond funds over stock funds. Banks are using their low cost deposits to purchase high quality bonds to boost their earnings power. Until banks start making more loans and reducing their holdings of securities, we could have a weak recovery. Eventually the lower returns on bonds will encourage investors and banks to take on more risk by investing in stocks and making loans.

Now we will take a look at our various asset class strategies. We are changing our format from previous reports to include some comments from other members of our staff so you will become more familiar with their special expertise.

Large Cap Stocks: Our Blue Chip Strategy rose 15.53% in the third quarter versus a 15.56% gain for the S&P 500 Index. For the year-to-date, the Blue Chips are up 12.06%, trailing the S&P 500 which is up 19.33%. Caterpillar was the strongest holding in the portfolio, rising 56.9% during the third quarter as investors expect a strong recovery in global capital spending. With many governments pursuing stimulus programs, Caterpillar should benefit from

lots of road building. The financial stocks were also strong performers with American Express gaining 46.8%, General Electric up 41.2%, and Bank of America and JP Morgan both up 28%. The only position that declined in value during the third quarter was Exxon Mobil, but it only fell 1.26%. We expect our Blue Chips to generate further gains as the global recovery takes hold and they benefit from a cheaper dollar. The weak dollar has already boosted exports and we think it will lead to a stronger than expected recovery.

Small Cap Stocks: The Small Cap Value Strategy rose another 25.31% in the third quarter versus the Russell 2000 Index gain of 19.28%. In the first three quarters of 2009, the Small Cap Value Strategy is up 56.13% against a gain of 22.43% for the Russell 2000. We took the opportunity to book some additional gains in Dollar Thrifty Group and used the proceeds to acquire new positions. The research summaries for each new stock are included for those clients that have an allocation to the small caps. The portfolio holding that exhibited the strongest gain during the quarter was PRG-Schultz, the audit recovery firm, who rose 107%. Dollar Thrifty was right behind, gaining 97%. Jackson Hewitt Tax Service was our weakest performer, dropping 18%. They had a weak earnings report as fewer customers decided to pay for tax return assistance in the weak economy. We swapped our position in Air Transport Services Group, an air freight and aircraft leasing firm, into Aircastle, Ltd. Aircastle is an aircraft leasing firm that has remained profitable during the recession and pays a nice dividend. We gave up on our position in Meridian Resources, the oil and gas exploration firm. They struggled to increase their reserves and faced debt covenant issues with the drop in natural gas prices. We have exposure to economically sensitive companies, so if the recovery builds momentum, our small cap portfolio should perform well. Even if the recovery is weaker than we anticipate, businesses cut costs so dramatically last year that any improvement in revenues should lead to a nice boost in profits.

High Yield Convertible Securities: The Convertible Securities/High Yield Strategy rose 20.65% in the third quarter versus gains of 15.89% for the Merrill High Yield Index and 14.48% for the Merrill Convertible Index. Year-to-date our portfolio is up 62.55% versus 39.41% and 47.67% for the respective Merrill indices. The tightening in credit spreads shown in Graph 2 is responsible for most of the gains in the high yield sector this year. Our convertible bond position in Yellow Corp, the trucking company, was our biggest gainer, up 103%, as they reached agreement with their unions to lower their costs and some debt covenants were relaxed by their creditors. They still need to see a strengthening of activity to generate more revenues. Many holdings that were considered “distressed” just a few months ago are now expected to survive as business improves. We anticipate that some of our convertible bonds may actually go “in the money” as their issuer’s underlying stock price rises above the conversion price. We also added some new positions that offer protection against a weak dollar and potential inflation. Coeur D’Alene Mines is a gold and silver mining company that has new mines coming online this year that will substantially boost production. We purchased our bonds at a yield over 11.50%. We purchased bonds issued by Stillwater Mining Co. that yield over 9.50%. Stillwater is a platinum and palladium miner that is the only domestic pro-

ducer of these metals. Their business will pick up as auto manufacturing rebounds. Bargains in the high yield sector are harder to find, but more new issues are becoming available as the credit markets improve.

Intermediate Bonds: Our Intermediate Taxable Bond Portfolio rose 4.70% for the quarter, versus a gain of 3.30% for the Citigroup 1-10 Year Government/Corporate index. Our portfolio is now up 8.93% year-to-date while the Citigroup Index has gained 4.96%. The Intermediate Tax Exempt Bond Portfolio gained 3.29% in the third quarter versus a 3.63% gain for the Merrill Lynch 3-7 Year Insured Bond Index. Our tax exempt strategy is up 5.59% year-to-date while the Merrill Lynch index has gained 6.58%. Our taxable bonds continue to outperform as a result of our strategic over-weighting to corporate bonds. As the economy regains traction, we expect upward pressure on interest rates. The Federal Reserve faces a difficult proposition as they balance the need for continued monetary stimulus in the near term with the risk of unacceptably high inflation in the longer term if they withdraw the stimulus too late. While a future with uncomfortably high inflation is not a foregone conclusion, we will continue to build a position in Treasury Inflation Indexed Securities to protect the portfolio from that possibility. Additionally, we expect the federal government's current fiscal situation will inevitably result in higher marginal tax rates. With this in mind, current market yields for intermediate and longer term municipal bonds offer a compelling value relative to taxable government bonds.

We do not want to sound too optimistic, but the financial markets are in a much better situation than one year ago. The vigorous stock market rally since March may need to take a breather, but the longer term outlook is positive as the animal spirits of the U.S. economy reassert their powers.